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The Moves Against Inflation

THE President's message to Congress on April 27, and the sweeping price control order issued by the Office of Price Administration on the 28th, came at an appropriate time. The inflationary danger is growing steadily, and more effective measures to keep it under control are needed. Although prices of staple commodities have advanced little during the past three months, prices of finished goods, wage scales and the cost of living have continued to rise, and the forces that are lifting them will plainly become stronger as time goes on.

Most of the important developments of the past month fall into an inflationary pattern. The War Production Board has been active in placing further limitations on the manufacture of consumers' goods; and within a few weeks the output of most consumers' durable goods will cease almost entirely, while supplies of some non-durable goods are being restricted beyond expectations. At the same time prospective government spending, which will add to consumer income, has been mounting.

The increase from $56 billions to $70 billions in the Budget Bureau's estimate of war expenditures in the fiscal year 1943 is a change of great significance. Unless the increase is to be achieved only through higher prices, in which case it will be of no help in winning the war, it will represent a physical expansion of the war effort. In part this will be accomplished by increasing aggregate production; but it will also cut deeper into civilian activity, for the critical shipping situation and shortages of materials impose limits on the ability to expand war production continuously without reducing output of civilian goods further. Meanwhile the workers who turn from making peace goods to war goods will still have their wages, and in most cases higher wages, to spend.

The "Inflationary Gap"

This is the heart of the inflation problem. The greater the conversion of mills and factories to war production, the greater is the "inflationary gap" between the incomes of consumers and the quantity of goods they can buy. In the statement accompanying its price order the O.P.A. estimated the total of individual incomes in 1942 at $117 billions and personal taxes and savings at $31 billions, leaving $86 billions available for spending. Against this it estimated the supply of consumers' goods and services left after the government's requirements, at present prices, at $69 billions. The difference is $17 billions. This calculation provides in simple terms a measure of the inflationary force.

Actually, of course, there will be no "gap" when the year's income account is finally balanced. All the dollars paid to individuals will be paid in taxes, saved, or spent. If the $17 billion is saved and put in war bonds or taken by taxation, the amount spent will equal the supply of goods at present values. But if the amount spent rises without an equivalent increase in available goods the money value of the goods, i.e. their prices, will be greater. Moreover, price advances tend to spiral, because they result in an increase of money income.

The foregoing analysis will not be new to the people of this country. The inflationary danger has been evident since the defense program was started, and especially since it became plain that both guns and butter could not be provided. Economists have agreed that the attack on the problem must be from all sides, with the basic emphasis upon work to produce the greatest possible quantity of goods, upon taxes and saving to turn income into the Treasury, and upon price and wage stabilization to keep down the cost of the war and the cost of living.

The chief criticism of the Government has been against the lack of a complete and rounded policy to accomplish these purposes. When tax rates were increased the people having the largest part of the income increase were relatively untouched. When a price control law was enacted special provisions almost nullified its control of farm prices, and wage rates were exempted. These exceptions have

permitted the inflationary forces to gather a momentum which gravely complicates the present problem.

The President's Seven Principles

The new moves against the upward price spiral consist of the President's seven-point program formulated in his message to Congress, and one specific action, — the monumental price-freezing order covering virtually all the consumer goods which the Price Control Act permits. The President told the nation:

(1) that personal and corporate earnings must be taxed heavily;

(2) that ceilings on prices must be set;

(3) that remuneration for work must be stabilized;

(4) that prices received by farmers must be stabilized;

(5) that all citizens should buy war bonds;

(6) that scarce commodities must be rationed; and

(7) that buying on credit must be discouraged and repayment of debt and mortgages encouraged.

To state these principles is itself a forward step. The first need in formulating any policy is to define objectives. The second and the last three of the seven points are already accepted as part of the national policy, and the great influence of the President and the patriotism and self-interest of the people alike should procure the observance needed if they are to be effective. The last point particularly is one which has not been stressed sufficiently in most comment on the inflation problem. Every dollar of debt that is paid off now puts a dollar in the creditor's hands for possible investment in war bonds; it limits the total debt that will be outstanding at the end of the war; and it puts the debtor in stronger financial condition to withstand whatever the uncertain future will bring. Also, debt can only be paid by saving, which means abstaining from present consumption and reducing the demand for goods.

But while each of the seven points is indispensable in an integrated program, the first, third and fourth are now of principal importance, for these cover the areas where the effort to prevent inflation has heretofore proved weakest. The real question in many minds is how effectively, in these areas, the principles will be applied.

The President says: "We must tax heavily and in that process keep personal and corporate profits at a reasonable rate, the word 'reasonable' being defined at a low level." Since surplus income is agreed to be the chief menace, this is a sound doctrine. The President does not recommend in the message a definite program for putting the doctrine into effect. The only specific recommendations are that "undue" or "excess" profits be taken by taxation, and a new proposal that taxes should take away all income in excess of $25,000 received by any American citizen.

Where the Inflationary Danger Lies

Every month that passes, however, makes clearer the kind of tax program that is needed. The principal threat of inflation lies in the swelling payrolls of the mass of consumers, who buy the bulk of the goods and services available. The last issue of this Letter contained an article showing, among other evidence too lengthy to repeat, that 70 per cent of the increase in national income in 1941 was in wages and salaries. Factory payrolls increased 17 per cent during 1940, 39 per cent during 1941, and 7 per cent through March this year, an aggregate rise over the period of 73 per cent. Taxation for the purpose of curtailing spending should reach this increase either through a sales tax, a tax on wage payments at the source, or reduced income tax exemptions and high rates on the lower brackets. The taxes on higher incomes alone, although properly at high and progressive rates, cannot possibly have the necessary effect because they reach a small minority of people and a small part of the consumer demand.

The proposed limitation of personal incomes to $25,000 probably would affect hardly more than 10,000 people. Randolph Paul, tax adviser to the Treasury, is quoted as estimating that under current tax proposals an individual would have to earn a gross of about $65,000 a year to have $25,000 income left. Available Treasury statistics, which cover 1940, do not show exactly how many incomes of $65,000 and over were reported in that year, since its figures are on net income and the bracket between $50,000 and $100,000 is not subdivided. However, the total number with incomes above $50,000 net was 13,900. Even if this figure is accepted without further modification, it demonstrates that the curtailment of consumption accomplished would be negligible as an inflation control.

It should be unnecessary to say that taxes in themselves are not a final objective of anti-inflationary policy. The final objective is to halt the upward spiral in prices and living costs. Prices, however, are but a measure of the relations between supply and demand. The function of taxation is to reduce demand, and unless it is reduced neither Mr. Henderson nor any other responsible authority believes that arbitrary ceilings on prices can be continuously effective.

Thus the relation of tax policy to the price control program is both direct and close. If the omission from the message of tax proposals adequate to absorb surplus buying power should mean that they will be omitted also

from the national policy, it is an unpropitious start for the price ceilings. It imposes upon them a handicap that will become heavier as the stocks of goods on merchants' shelves are reduced.

Farm Price and Wage Stabilization

The President's proposals for stabilization of farm prices and wages are, in effect, complementary. The rise in farm prices has been based on the parity formula, which has been the basis of the government action to raise prices, and under which the parity rises automatically as the prices of things farmers buy advance. Conversely, the arguments of labor leaders for higher wages have been based largely on the rising cost of living. Each therefore has tended to push the other up, and both have profited to the disadvantage of the white collar and professional workers, small business men, pensioners, unorganized labor, and all other people whose living costs have been rising more than their incomes.

The President proposes that ceilings on farm prices should be permitted at parity instead of 110 per cent of parity or higher, the minimums fixed in the Price Control Act. He asks Congress for legislation to that end. With respect to wages, he states his belief that "stabilization of the cost of living will mean that wages in general can and should be kept at existing scales." He does not propose to freeze wages by law, but to leave the task of stabilization in the hands of the War Labor Board, which he says will "continue to give due consideration to inequalities and the elimination of sub-standards of living."

A reduction in the level at which farm price ceilings are permitted is desirable. The rise in farm prices during the war has exceeded the rise in any other price group by a substantial margin. In the Bureau of Labor Statistics index the farm products group has advanced more than 70 per cent since August 1939, while all other groups have advanced 24 per cent. Just as the O.P.A.'s effort to hold down living costs by selective price control was weakened by the virtual exclusion of farm prices from its jurisdiction, so the new blanket ceiling is weakened by the exclusion of farm products which are not up to the permissible ceiling level. These products include eggs and poultry, butter, cheese, canned milk, flour, mutton and lamb, dried prunes and dried beans. A price control program which exempts foods of this importance is handicapped at the start.

On the other hand, it will not be denied that there are sub-standard farmers, and are these likely to overlook the exception mentioned above for sub-standard labor? Farm leaders and farm members of Congress will naturally make a point of the fact that it is proposed to limit farm prices by legislation, while wages are to be left in the discretion of a board under a directive which gives leeway for advances and permits them to be settled as heretofore by negotiation. According to a statement of the Washington correspondent of the New York Times on April 30, the chairman of the War Labor Board proposes to deal with wages flexibly. But if farm ceilings are fixed by law they will flex only as the parity price changes. Mr. Henderson tells retailers they will under no circumstances be permitted to raise their prices above the new ceilings; and any flexibility in manufacturers' and wholesalers' prices will be almost wholly downward and will come only after freezing.

There are strong arguments for flexibility in controls of every kind, for economic relations are naturally flexible, and all arbitrary freezing or control sets up strains. However, the strains are multiplied when some prices and wages are free to fluctuate and others are frozen. Likewise, people will bear burdens better if all are dealt with alike. Inequities provoke disunity, and unity of purpose and effort are vital to the winning of the war. Apart from the counter-inflationary effects, the soundest argument for freezing wages and farm prices, and making adjustments thereafter as necessary, is that the security and morale of those who have been caught by the rise in living costs would be lifted. They feel with justice that the higher farm and labor incomes have been, in some part at least, at their expense.

The Blanket Price Ceiling

The price-freezing order has been in preparation for a long time. When Canada established its blanket ceilings on December 1, 1941, Mr. Henderson and his staff took the view that measures suitable for that country were unsuitable here, due to greater population and area, greater complexity of distribution and trade, and correspondingly greater difficulties of enforcement. Above all, perhaps, was the continuing belief in the efficacy of selective controls, and the argument that Canada was in the war while the United States was not.

After Pearl Harbor the viewpoint of the O.P.A. began to change rapidly, probably for two main reasons. One was the more rapid rise in the cost of living, in which Mr. Henderson correctly saw growing danger of an inflationary spiral. The second was the spread of restrictions on production of consumers' goods. In each case where it became evident that goods would become scarce, a decision had to be made whether to allow their distribution to be worked out through market prices, or whether ceilings, and in some cases rationing, should be established. In accord with the policy of keeping the price level down, the decision has been uniformly for ceilings; and in recent

weeks ceilings have become so widespread, and have extended so far into distribution channels, that the policy of selective control has seemed to be merging of its own accord into one of a general freezing.

It is safe to say that this price order will have more widespread effects upon distributive trade in this country than any other government action ever taken. At one stroke it freezes relationships of almost incomprehensible complexity, all in terms of those existing in an arbitrary past period, March of this year. Except as later adjustments are made, it will freeze prices that are below replacement costs as well as those that are above; distributors' margins that are inadequate as well as those that are excessive; and losses as well as profits. It penalizes retailers who have operated on small margins and kept prices down. It raises limitless questions as to grades and standards. In due course, and in many cases immediately, these maladjustments will create problems of the most difficult nature, while over all are the problems of enforcement and of adjustment to future changes in costs.

"Roll Back" Denied

In discussions before issuance of the order, retailers widely urged that the base period for wholesalers' and manufacturers' prices should be set at earlier dates than that for retail prices, in order to protect those who had not yet marked prices up to a replacement basis. Section 4 of the order makes provision for such a "roll back" in cases of inequity, and the O.P.A. has indicated that it will have the problem continuously before it.

However, the O.P.A. decided against establishment of differing base periods at this time. In this decision it was governed by two principal considerations. One was that the wholesale ceiling prices are prices upon deliveries made in March, and not upon orders accepted in March for future delivery. This in itself provides a lag in favor of the retailer. The second was the belief in the O.P.A. that the profits of consumer goods manufacturers, wholesalers and retailers could all be narrowed and that their costs could be reduced, — for example, through standardization and simplification of merchandise and through curtailment of some of the services which retailers now render.

Because of this belief, the policy is to put pressure on margins, and to force the trades to absorb the "roll back" by reducing them. In the case of cotton gray goods, for example, the sliding scale of mill prices has been replaced by a price related to the highest price of cotton in March, the base month. Yet cotton could advance 1.10 cents beyond that price before reaching the ceiling level. In case of such an advance, the intent evidently is that the mill will bear the higher cost. If this should endanger necessary cotton goods production, the cost presumably would be divided, by ceiling revisions, among the converter, garment manufacturer, distributors and others on the line to the retailer.

The pressure on margins is obviously a matter of great moment for the consumer goods trades. Undoubtedly it is in the interest of the war effort to simplify goods and reduce costs in every practicable way, and greater progress will be made now than in normal times when consumers' choice has fuller sway. The reliance of the O.P.A. upon reducing profits all along the line, however, prompts two comments. One is that conditions in the distributive trades will change rapidly within the present year. A reduction of profit margins now will have multiplied effects on earnings later, when the volume of consumer goods declines and merchants' fixed costs have to be covered by smaller sales. The profits which the O.P.A. is counting upon to absorb the "roll back" were made in a year of increasing production and sales at advancing prices. But the trend of consumer goods production and of profits (see the subsequent article on first quarter 1942 earnings) evidently is now turning downward. Prices will now be frozen, and sales eventually will decline.

In the second place, a squeeze in profits will necessarily reduce the tax base, making the Treasury bear a part of the decline.

The O.P.A. is aware of the difficulties that it will face. It gives notice that the "general regulation will be subject to many refinements and broad revisions. Supplementary regulations will be issued. These will seek to cure difficulties of a technical nature. More important, they will change prices and price margins."

Upon this statement distributors who are squeezed will have to rely. The O.P.A. makes one further significant declaration: "One thing should be fairly understood. Retail prices will not be increased. * * * Adjustments may be made in manufacturers' and wholesalers' prices. * * * But the ceiling will not be punctured."

The Canadian Experience

In formulating the freezing order the O.P.A. had the experience of Canada to draw upon. The Canadian program has been much admired in the United States, and judged solely by the trend of the wholesale price index Canada's effort to check the inflationary price rise appears to have been effective. In the four months ended March, 1942, the Canadian price index advanced but one per cent, while in the United States wholesale prices rose more than 6 per cent. The Canadian cost of living index also remained practically unchanged during the period, and the provision for a wage bonus in proportion to any rise in living costs has not come into operation.

The chief difference between Canadian price-freezing and ours is that in Canada, although there are some exemptions, agricultural prices generally and wages are both included in the regulation. Moreover, the application of the price ceiling concurrently to manufacturers, wholesalers, and retailers, as in our measure, was there considered impracticable. Consequently, only retail prices quoted to the consumer were frozen. The adjustment of manufacturers' and wholesalers' margins and prices in line with retail levels was left as largely as possible to the trades, subject to approval and intervention by the Wartime Prices and Trade Board.

Canada decided in the beginning to pay subsidies in cases where margins would not absorb replacement costs or rising costs of materials, the latter applying particularly to imported materials, over which the Dominion naturally had no control. A Commodity Price Stabilization Corporation was organized and provided with $10,000,000 of government funds to pay subsidies, at different stages of manufacturing and distribution as necessary, to keep retail prices at an even keel. For example, coal mine operators were given a subsidy to offset higher costs resulting from an order for payment of a bonus to miners. About one-half of a 15 per cent rise in leather costs is being covered by subsidy; the other half must be absorbed by manufacturers and distributors.

The cost of subsidies during the first four months has been estimated at only about $2,000,000, but estimates of the payments that eventually may be required run to very high figures. If the rising price trend in United States products crossing the border is checked, the strain on the Canadian price structure and the demand for subsidies will be eased considerably, but it will always be true that a subsidy system is an inducement to claims and allowances at the expense of the taxpayer.

In this country no mention of possible subsidies to avert puncturing of retail ceilings appears in the price-freezing order or the accompanying statements. Evidently our Government depends upon its bargaining power to hold prices of imported commodities stable, upon its control to keep shipping costs in hand, and upon its over-all program to avert inflationary advances in domestic materials, manufacturing and distributing costs, and wages.

This brings the discussion full circle, back to the need of a complete and rounded program. No gift of prophecy is required to show that unless its policies are successful in all these respects, and the surplus buying power that is building up is diverted to paying for the war effort, this country will in due course find inflationary pressure pushing irresistibly against the ceilings. In all other countries the outcome has been hidden price increases, and "black markets". The responsibility for establishing an effective program rests with the Government, the responsibility for whole-hearted co-operation and compliance with every element of the population.

First Quarter Earnings

The upward trend of corporation earnings, which since 1938 has accompanied the rapid expansion of industrial production, showed its first important reversal in the first quarter of this year, according to reports of leading companies issued during the past month. In a majority of cases, the net income after taxes of industrial corporations was less than a year ago, despite the further expansion in volume of production and sales.

A group of 280 manufacturing, mining, trade and service companies, employing an aggregate capital and surplus of approximately $10,790 millions at the beginning of this year, had a combined net income in the first quarter of $243 millions after taxes. This was 25 per cent below the total for the same companies in the first quarter of 1941, and 26 per cent below that of the fourth quarter.

The following quarterly totals of this group show the tendency for net income after taxes to flatten out last year, and then turn downward, although volume of business continued to increase:

1941	First quarter	$322,665,000
	Second "	326,704,000
	Third "	324,822,000
	Fourth "	326,965,000
1942	First "	242,852,000

Large public utility systems supplying electric, gas and other services, and reporting for the twelve months ended March 31, had an average gain in revenue of 6 per cent as compared with the year before, but a decline of 8 per cent in net income. Separate first quarter figures issued by some systems showed even sharper declines in the net.

Railroad revenue for all Class 1 systems in March was the highest for any month since October 1929, and net income for the month and for the quarter showed an increase as compared with a year ago, despite the rise in operating expenses and taxes.

Summary By Groups

The accompanying tabulation gives a summary by major industrial groups, showing the comparative net income after taxes and other charges in the first quarters of 1941 and 1942, the net worth, and the annual rate of return.

An examination of the results will show the highly uneven changes among different industrial groups. About three-fifths of the individual companies reporting to date had lower earnings than a year ago. As pointed out heretofore, the promptly published reports of a

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST QUARTER

Net Income is Shown After Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends—Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

No.	Industrial Groups	Net Income First Quarter 1941	Net Income First Quarter 1942	Per Cent Change	Net Worth January 1 1941	Net Worth January 1 1942	Annual Rate of Return % 1941	Annual Rate of Return % 1942
5	Baking	$ 4,059	$ 3,928	— 3.2	$231,987	$209,495	7.0	7.5
15	Other food and beverage	15,906	13,200	— 17.0	477,054	487,074	13.3	10.8
11	Textiles and apparel	3,957	2,033	— 48.6	112,111	117,829	14.1	6.9
10	Paper products	2,342	3,229	+ 37.9	134,623	138,971	7.0	9.3
21	Chemicals, drugs, etc.	47,824	39,189	— 18.1	1,326,518	1,385,883	14.4	11.3
9	Petroleum products	20,928	19,317	— 7.7	1,256,639	1,277,678	6.7	6.0
13	Stone, clay and glass	8,108	4,681	— 42.3	281,595	288,404	11.5	6.5
24	Iron and steel	68,153	49,910	— 26.8	2,356,589	2,470,917	11.6	8.1
8	Building equipment	4,629	4,045	— 12.6	199,343	202,230	9.3	8.0
8	Electrical equipment	19,843	16,960	— 14.5	568,226	627,821	14.0	10.8
19	Machinery	8,354	6,491	— 22.3	194,534	216,337	17.2	12.0
4	Office equipment	3,556	4,060	+ 14.2	118,419	120,262	12.0	13.5
7	Automobiles	66,142	24,675	— 62.7	1,157,603	1,190,642	22.8	8.3
17	Auto equipment	7,322	8,027	+ 9.6	175,265	192,185	16.7	16.7
8	Railway equipment	4,354	4,174	— 4.1	164,240	174,683	10.6	9.6
31	Metal products—misc.	16,256	18,528	+ 14.0	487,218	513,567	13.4	14.4
21	Misc. manufacturing	5,450	4,191	— 23.1	229,446	241,356	9.5	7.0
231	Total manufacturing	307,183	226,638	— 26.2	9,471,410	9,855,334	13.0	9.2
7	Coal mining	1,536*	1,294*	— 15.8	164,408	168,516	3.7	3.1
9	Metal mining	4,651*	4,007*	— 13.8	210,325	209,059	8.8	7.7
11	Mining, quarrying—misc.	4,437*	5,090*	+ 14.7	166,377	170,720	10.7	11.9
13	Trade (whol. and retail)	3,121	3,516	+ 12.7	214,345	226,220	5.8	6.2
9	Service and construction	1,737	2,307	+ 32.8	153,793	160,567	4.5	5.8
280	Total	$322,665	$242,852	— 24.7	$10,380,658	$10,790,416	12.4	9.0

*Before certain charges.

limited number of companies available for such tabulations are not necessarily typical of results throughout the industries represented, nor of average earnings for business as a whole, but provide useful indications of current trends.

Sales figures reported by 60 of the manufacturing companies aggregated $970 millions in the first quarter of 1941 and $1,268 millions in the first quarter this year, an increase of 31 per cent. Ordinarily a moderate gain in sales results in a sharp increase of net income, because of the lowering of unit production and overhead costs. Instead, there was an actual decrease in dollar net income, which meant a still greater decrease in the margin of profit per unit of product or per dollar of sales.

The fact that net income decreased this year was caused in large measure by the steep increase in reserves for federal income and excess profits taxes. Other factors noted in different reports were the effects of curtailing peacetime output, the cost of converting to war production, and the rise in labor, material and other operating costs during the past year.

Reduced net earnings, combined with a drain of cash for taxes, inventories, receivables and plant expansion, have been cited by the executive heads of a number of companies as the reason for reduction of dividends since the beginning of the year, or for possible cuts to come later, despite the attainment of new high records in volume of business.

Taxes Take 67 Per Cent of Net Income

Tax details available for 110 of the manufacturing companies which have reported show that the combined net income *before* taxes increased from $402 millions in the first quarter of 1941 to $448 millions in the first quarter of 1942, or by $46 millions. Reserves for federal income and excess profits taxes for the two periods, however, increased from $184 millions to $300 millions, or by $116 millions, absorbing two and a half times the entire increase in the net before taxes. Such taxes took 46 per cent of the net income before taxes in the initial quarter of 1941, but 67 per cent in 1942.

A considerable number of the reports issued have contained some explanation as to the basis upon which reserves for first quarter taxes were computed. About one-fourth of these applied the existing 1941 rates; more than half allowed for a "moderate" or "substantial" increase in rates for normal tax, surtax and excess profits tax; and the remainder used the new high schedule of rates recently proposed by the Treasury.

Taxes Compared with First World War

The record height to which corporation taxes upon income have been carried during recent years, exceeding even the peak wartime rates of 1918, may be seen from the following table. This gives the Treasury statistics of all manufacturing corporations in the United

States (now numbering around 83,000) for selected years to 1939, the latest available, together with annual totals from our own tabulations of leading companies for 1939-1941, and first quarter totals for 1941-1942. While the three groups are not strictly comparable, they furnish a rough indication of trend.

Percentage of Net Income of Manufacturing Corporations Taken by Federal Income and Excess Profits Taxes
(In Millions of Dollars)

Group and Year	Net Income before Taxes	Fed. Inc. & E. P. Taxes	Per Cent of Net Income	Net Income after Taxes
All Mfg. Co.(a)				
1917........	$5,559	$1,327	23.8	$4,232
1918........	4,534	2,112	46.5	2,422
1919........	4,842*	1,359	28.1	3,483
1929........	4,498	544	12.1	3,954
1939........	3,218	634	19.8	2,579
125 Mfg. Co.(b)				
1939........	1,748	373	21.4	1,375
1940........	2,606	913	35.0	1,693
1941........	4,392	2,477	56.4	1,915
110 Mfg. Co.(c)				
1941-1 Qr.	402	184	45.8	218
1942-1 Qr.	448	300	67.0	148

(a) From Treasury Department "Statistics of Income" for all manufacturing corporations in the U. S.; excludes intercorporate dividends. (b) From tabulation of 125 large manufacturing companies, each having taxes of more than $5,000,000 payable on 1941 incomes. (c) From tabulation of 110 manufacturing companies whose first quarter reports show tax reserves.

It will be recalled that the revenue acts applicable to the year 1918 included an excess profits tax with rates up to 65 per cent on the excess net income over 8 per cent on invested capital, and a war profits tax with rates up to 80 per cent on the increase over prewar in net income. The normal income tax, however, applying in 1918 to all corporations, including the large numbers which had no increase in net income as a result of the war, was but 12 per cent.

The latter rate contrasts with the 31 per cent combined normal tax and surtax on net income imposed by the Revenue Act of 1941, and the 55 per cent recently proposed by the Treasury, in addition to which there is again an excess profits tax with existing rates up to 60 per cent and proposed rates up to 75 per cent.

Total corporate tax liability in recent years has also been increased rapidly by the growth in state and local taxes, social security taxes and miscellaneous federal taxes. These are not shown in the table, but amounted to $1,585 millions in 1939, compared with $617 millions in 1929 and but $312 millions in 1918.

The Taxation of War Profits

That the President should have made the limitation of business profits an integral part of the general program for averting inflation is altogether logical and proper. In time of war, which should be a period of sacrifice for all, it is not expected that business concerns will be permitted to retain for their own use the large profits that must inevitably accrue directly and indirectly from the enormous government expenditures. The question now calling for wise decision is not whether or not profits should be limited, but rather how much and by what methods.

This, of course, is not the first time that the question of profit limitation has come up. Apart from legitimate reasons for heavy taxation of profits in wartime, there is always a vast amount of agitation against the corporations, founded on ignorance and prejudice. The question therefore has been a "live" one ever since the arms program began.

First, there was the Vinson-Trammell Act of 1940, enacted at the outset of the arms program and providing for fixed percentage profit limits on war contracts. This scheme, proving unworkable, was soon abandoned in favor of dealing with profits through the regular revenue acts and the Acts of 1940 and 1941 provided for stiff increases in both "normal" and "excess" profits taxes. Within the last month Congress, in a hasty and ill-considered reaction to testimony on a few isolated but widely publicized cases of excessive profits on war contracts, resurrected (happily unsuccessfully) the discredited fixed ceiling principle of the Vinson-Trammell Act, while at the same time conducting hearings on new revenue proposals that embody further drastic increases on both individual and corporate incomes.

The President's Recommendations

In his statement to Congress on inflation, the President's references to profits were as follows:

> To keep the cost of living from spiraling upward, we must tax heavily, and in that process keep personal and corporate profits at a reasonable rate, the word "reasonable" being defined at a low level.
>
> Legislation is necessary, and the subject is now under consideration in the House of Representatives. Its purpose is to keep excess profits down and, at the same time, raise further large sums for the financing of the war. On this subject, I believe that the objective can be attained through tax processes. * * * Profits must be taxed to the utmost limit consistent with continued production. This means all business profits — not only in making munitions, but in making or selling anything else. Under the proposed new tax law we seek to take by taxation all undue or excess profits. It is incumbent upon the Congress to define undue or excess profits; and anything in excess of that specific figure should go to the government.
>
> One of our difficulties is to write a law in which some clever people will not find loopholes, or in which some businesses will not be equitably included. I have suggested to the chairman of the Committee on Ways and Means in the House of Representatives that some blanket clause could well cover, by a special tax, all profits of any kind of business which exceeds the expressed definition of the legal profit figure.

It will be seen that the President's recommendations were couched in general rather than specific terms. Much that he says should receive unqualified endorsement.

There can be little disagreement with the purpose "to keep excess profits down" and

"raise further large sums for the financing of the war." His statement of belief that "the objective can be attained through tax processes" would seem to imply a ruling out of attempts to apply ceilings on specific contracts. This is all to the good, for such plans have been shown to involve prohibitive difficulties and injustices.

With the general proposition that the limitation of corporate profits has much to do with the cost of living, there can only be qualified assent. As pointed out elsewhere in these pages, where the danger of inflation really arises is in the so-called "inflationary gap" — brought about on the one hand by the swelling mass of individual incomes (especially in the low income brackets) under the influence of government expenditures, and, on the other, by the steadily shrinking quantity of available civilian goods upon which these incomes can be spent. Under present conditions, higher corporation taxes can have little or no anti-inflationary effect, both for the reason that corporate income after taxes is already beginning to decline, as shown by the earnings reports for the first quarter, and because of the increasing difficulty on account of priorities for corporations to spend their earnings except for necessary arms activities.

While it is true that a piling up of huge untaxed profits in the corporations would act as a powerful stimulant to wage increases, this situation is already being taken care of by the taxes now in effect; indeed the point has been reached where there is grave doubt as to how much further taxes can be raised without weakening of incentive for economy and efficiency, impairing the financial strength of some corporations, and actually slowing down the pace of production upon which success in the war effort depends.

It is critically important to know what is meant by keeping profits at "low" levels, taxing to the "utmost" consistent with production, taking by taxation "all undue and excess profits," etc. Obviously, everything depends upon the interpretation of these terms by the taxing authorities.

The Treasury Tax Proposals

The above statements by the President, and especially his reference to tax proposals now before Congress, have focused attention more than ever upon the program presented on behalf of the Treasury by Secretary Morganthau and his advisors to the House Ways and Means Committee in March.

Briefly summarized, this program called for new taxes of $7.6 billions, of which approximately $3 billions would come from the corporations, an increase of about 40 per cent. To effectuate this program of corporation taxes, the Treasury proposed raising the combined normal and surtax from the present 31 per cent to 55 per cent, and lifting the graduated excess profits tax 15 percentage points in each bracket to a maximum rate of 75 per cent.

As we go to press, Treasury and Congressional tax experts are reported to have agreed upon recommendations to the Ways and Means Committee, embodying a somewhat lower combined normal and surtax, possibly 40 or 45 per cent, and a much steeper excess profits tax of 90 per cent or more.

Either of these programs would place heavy additional burdens upon productive industry, and the problem arises as to the effect upon the corporations and the economy in general.

War Profits vs Excess Profits Taxes

In weighing this problem one of the most important considerations is the general social philosophy guiding the tax program. If what is sought is a true war profits tax—that is, a tax that will be aimed primarily at recapturing a substantial or even a main share of the increment of business profits caused by war stimulation—that is a sound objective. On the other hand, if a tax is levied against all profits in excess of some arbitrarily selected percentage return upon capital, — whether such earnings have been increased by war or not—with the apparent objective of effecting social reform through a redistribution of wealth, that is not a proper wartime tax.

One of the clearest statements that has been made of the fundamental difference between the two types of taxes appeared in testimony of the former Secretary of the Treasury, Mr. McAdoo, to the House Ways and Means Committee in August, 1918, from which we quote as follows:

> The distinction between a war profits tax and excess profits tax is not a matter of form, but of substance. By a war profits tax we mean a tax upon profits in excess of those realized before the war. By an excess profits tax we mean a tax upon profits in excess of a given return upon capital . . .
>
> A war profits tax finds it sanction in the conviction of all patriotic men, of whatever economic or political school, that no one should profit largely by the war. The excess profits tax must rest upon the wholly indefensible notion that it is a function of taxation to bring all profits down to one level with relation to the amount of capital invested, and to deprive industry, foresight, and sagacity of their fruits. The excess profits tax exempts capital, and burdens brains, ability, and energy. The excess profits tax falls less heavily on big business than on small business, because big business is generally over-capitalized and small businesses are often undercapitalized.
>
> The war profits tax would tax all war profits at one high rate; the excess profits tax does, and for safety must, tax all excess profits at lower and graduated rates. Any graduated tax upon corporations is indefensible in theory, for corporations are only aggregations of individuals, and by such a tax the numerous small stockholders of a great corporation may be taxed at a higher rate than the very wealthy stockholders of a relatively smaller corporation.

Secretary Morgenthau, in his statement to the Ways and Means Committee in March, recognized the sound principle of a true war profits tax when he said:

> A substantial share of the increased corporation tax should fall on excess profits. Taxes paid from such

profits have less disrupting effects on business than taxes which are generally applicable to all corporate earnings irrespective of the rate of return. A tax which absorbs excess profits still leaves the corporate taxpayer with a sufficient margin of income for dividends and safety.

On the other hand, a tax which dips too deeply into the income of low earning corporations may seriously affect their debt-paying ability, if not their very existence.

While the Secretary did not attempt to define excess profits in his statement, the acquiescence of the Treasury in the retention of the alternative choice to the corporation of figuring excess profits on either the pre-war average earnings base or the invested capital base preserves the principle of taxing increases in profits due to the war, and at the same time makes allowances for concerns having abnormally low earnings in the case period.

Effects of a 55 Per Cent Normal and Surtax

These sound precepts are difficult to reconcile with the Treasury's proposal to increase the combined normal and surtax rate to 55 per cent. Such a tax has little or no relation to capacity to pay, and bears hardest on those concerns whose earnings have not increased appreciably as a result of the war, or may even have decreased. Conservatively managed companies of stable earnings like the tobacco companies, whose long established dividend record has entitled their shares to an investment rating, are being forced to cut dividends. Among the worst hit are the utilities, which have no way of absorbing such drastic tax increases and whose securities are being pushed to new all-time lows.

All this has various ill effects.

In the first place, it is unfair to the corporate shareholder who finds himself taxed twice—once in the corporation and a second time when the income is distributed to him as dividends. Theoretically, there is much to be said for the principle that income ought not to be taxed in the corporation at all but only as dividends are distributed to the shareholder when the tax would apply at rates appropriate to the shareholder's income bracket.

Practically, however, there are difficulties to this scheme, and taxation of corporations is an accepted part of the tax structure of most countries. All the same, the basic injustice of this double taxation should not be overlooked, and was recognized in the tax laws prior to 1936 when dividends were exempted from individual normal taxes, though still subject to surtaxes. In Great Britain today the stockholder is allowed a credit against his tax liability equal to the amount of the normal tax paid by the corporation on the dividends he receives. In this country in the last war the normal tax was never raised above 12 per cent, although there were excess profits taxes up to 65 per cent and war taxes up to 80 per cent.

The effects of taxing the same income twice grow more serious, of course, as the rates increase, and become severe indeed under a 55 per cent normal-surtax imposed regardless of whether the corporation has more or less income out of which to pay the tax. Such taxes have the practical result of taxing the shareholders at the same rate, despite the fact that the large majority of the shareholders, owning a substantial proportion of the total stock, are persons of moderate or small means who under the graduated individual tax would pay much lower rates. Though workers in munitions industries, according to the President, should continue to be paid time and a half for more than 40 hours, for "otherwise their weekly pay envelopes would be reduced," stockholders large and small apparently are expected to take substantial reductions.

Who Gets the Dividends?

Nor should it be supposed that the overwhelming share of the total dividends distributed go to a few wealthy shareholders who can "afford" to take losses. According to the Temporary National Economic Committee (monograph 29), there were in 1937 between 8 and 9 million individual shareholders in this country. Recent evidence as to who gets the dividends may be had by comparing the total dividend payments reported by the Department of Commerce with total dividend receipts as reported in Treasury tax returns for 1940. Following are the figures by income groups:

Dividend Payments in 1940, and Dividend Receipts by Net Income Classes

	Amount	Per Cent of Total
Total dividend payments (excluding intercorporate)—Dept. of Commerce (a)	$4,150,000,000	
Dividend receipts reported on federal income tax returns, by net income classes (b)		
Over $1,000,000	72,704,000	1.7
500,000 to 1,000,000	50,443,000	1.2
300,000 to 500,000	67,859,000	1.6
150,000 to 300,000	138,402,000	3.3
100,000 to 150,000	126,763,000	3.0
50,000 to 100,000	311,415,000	7.5
25,000 to 50,000	413,324,000	10.0
10,000 to 25,000	597,867,000	14.4
5,000 to 10,000	427,679,000	10.3
Subtotal over $5,000	$2,206,455,000	53.0
Under $5,000 (c)	1,224,888,000	29.5
Total reported by Treasury	$3,431,343,000	82.5
Bal. not reported by Treasury	718,657,000	17.5
Total	$4,150,000,000	100.0

(a) From Department of Commerce "Survey of Current Business," June 1941, page 17. (b) From Treasury Department "Statistics of Income for 1940," Part 1 (preliminary), page 12. (c) Partly estimated by the Treasury.

It will be seen that 53 per cent of the total dividend payments was received by individuals having net incomes of *over* $5,000. The remaining 47 per cent was reported to the Treasury by individuals having net incomes *under* $5,000,

or was received by non-profit institutions (hospitals, schools, churches, etc.) as well as by individuals not filing returns or individuals filing returns but failing to report dividends (evidently small shareholders).

All these recipients would be affected by the tax rates proposed. At a time when we are preaching the necessity for savings, it is proposed to penalize heavily the very people who have been savers and have placed their savings in securities.

Reserves and Equity Capital

All recognize the desirability of the corporations building up ample reserves against post-war readjustments; yet this will be impossible unless the companies are permitted to make and retain adequate earnings. With the high rates at which corporations are working, they are forced to tie up their earnings in inventories, receivables, and plants, whereas their heavy taxes have to be paid promptly in cash. Thus, despite the substantial increase in earnings shown up to this year, large numbers of companies have been becoming less and less liquid, and have had to go increasingly into debt, contrary to the obvious desirability in such times to get out of debt.

Small corporations are especially hurt by excessive taxation, since such companies frequently lack adequate capital and need earnings for growth.

Constantly rising taxes, threatening the earning power of corporations, undoubtedly have been one of the chief factors destroying a large share of the market value of stocks. Today stock market averages are about 30 per cent below those prevailing at the outbreak of the war, whereas basic commodities are some 67 per cent higher. In many cases this has made difficult if not impossible the raising of new money by issues of equity capital. It has forced companies to resort to debt financing, although federal and state regulatory authorities have emphasized repeatedly the importance of equity financing instead. Paradoxically, such taxes hit hardest those corporations with the soundest financial structure, inasmuch as interest charges are an allowable deduction for tax purposes, while dividend charges are not.

Efficient and Inefficient Producers

Finally, there is the basic fallacy, implied in confiscatory excess profits taxation, that because a concern makes more than an average profit it is not giving the Government its money's worth. Take the case, for example, of two concerns, A and B, both selling exactly the same product. A is a high cost producer, and has a high price at which it is able to barely break even, or perhaps make a little money. B, on the other hand, finds that by virtue of better equipment, more experience, and better management it is able to cut substantially its price to the Government, and still make better than an average profit. Is this "profiteering," and is it in the interest of economy and efficiency in promoting the war effort to take away all incentive to such improvement in method and cost reduction by setting up an impassable boundary line of profits at say 6 per cent? Which concern is really doing the best job for the Government — the one that charges more and earns less, or the one that charges less and earns more?

In all other forms of endeavor it is generally recognized that the offering of some special reward acts as a spur to accomplishment. The extra pay to the wage-earner of time-and-a-half for overtime is based on this principle. Yet this theory of taxing away all profits above some "average" level would work in reverse. Such taxation penalizes the efficient and subsidizes the inefficient.

In cases where profits on war contracts have turned out to be larger than expected, there is a way to adjust these through repayments and renegotiation of contracts, and business men by and large will cooperate gladly with the Government in adjusting these situations. Many companies, having found costs under quantity production and improved methods lower than anticipated, have voluntarily effected substantial savings to the Government in this way. Notable cases that have been made public include $100,000,000 by the Sperry Corporation, $74,000,000 by North American Aviation, $73,000,000 by Bendix Aviation, $40,000,000 by Continental Motors, $26,000,000 by United Aircraft; and there have been many others.

The fact is that reputable business men do not look for, or want, large profits from the work of supplying the Government in this emergency. What they are really concerned about is the avoidance of losses that would impair the effectiveness of their organizations now and in the post-war period.

The Primary Consideration

It is of course necessary in times like these for taxes to be heavy, and no one has a right to complain merely because they are heavy. What is important is that taxes be apportioned fairly and with due regard for the objectives of war-time fiscal policy, which are the raising of funds for the Government, the avoidance of the dreaded spiral of inflation, and the maintenance of the industrial mechanism in good working order and running at top speed.

Concern over the effects of increasing taxation on the corporations arises not from any desire to make a sheltered class out of corporate stockholders (the high corporate rates currently in effect and the high individual tax rates of the stockholders have taken care of that). It arises rather from the fact that such taxes, while not effective in preventing infla-

tion, are taxes on the machinery that is responsible during the war for maintaining the output of vital supplies, and which after the war will be looked to for maintaining employment and supplying the goods needed to support and advance the standard of living. Yet because taxes upon the relatively few corporations are easier to collect and less politically dangerous than are taxes which reach millions of individuals more directly, there is a great temptation for government to dip again and again into what many seem to regard as an inexhaustible fund.

Secretary Morgenthau, in his statement to Congress, warned of the danger of excessive taxation to efficiency and incentive, and in a subsequent press interview stated that "we here still believe in the profit system and think that business should be allowed to make a reasonable profit," otherwise "it would resemble the case of killing the goose that laid the golden egg."

Sound tax policy must regard the corporations as agencies primarily for the production of goods and services rather than as agencies for raising government revenue. The basic consideration is the maintenance of the solvency and vitality of the industrial system on which the war effort and post-war progress depends.

Money and Banking

The program of government financing for May and June, announced by the Treasury late in April, is unusual both as to size and character. The program will embrace three kinds of issues, to raise $4 billions of new money over the two months, in addition to the drive to speed up the sales of war savings bonds.

Two of the issues are of the type with which the market is already familiar and comprise (1) $1,250 millions of 2 per cent bonds of approximately 10 years maturity, and (2) an increase in the regular weekly Treasury bill offering by $100 millions to $250 millions; while the third will represent a departure from the conventional type of offering and consist of an unspecified amount of 2½ per cent registered 20 to 25 year bonds which will be open to subscription, or "on tap," for an unspecified period. The latter bonds will not be eligible for purchase by commercial banks for 10 years and will not be transferable for 60 days.

This three-way offering represents an effort on the part of the Treasury to adapt its securities to the widest possible range of investors. Among the objectives are to place the maximum amount of the financing outside of the commercial banks, thus minimizing the inflationary effects, and to supply such financing as the banks will have to take in the form best adapted to their needs. By excluding commercial banks from the 20 to 25 year "tap" bonds for a period of years, the effect is to reserve this issue for long-term investors such as the insurance companies, savings banks, pension funds, trustees, etc., thus obtaining the funds outside the commercial banking system and preventing an undesirable increase in the holdings of long-term securities by the banks.

At the same time both the 10 year bonds and the enlarged bill issues may be expected to appeal to banks and other investors interested in intermediate or short maturities. The stepping up of the weekly bill issue carries forward the policy, initiated last month with the sale of $1½ billion 6 months Treasury certificates, of increasing the quantity of short-term paper available in the market for investment by banks and corporations. With excess reserves declining, as at present, it becomes more and more necessary for banks in particular to have adequate supplies of readily salable short-term investments which can be used as a means of adjusting their reserve position.

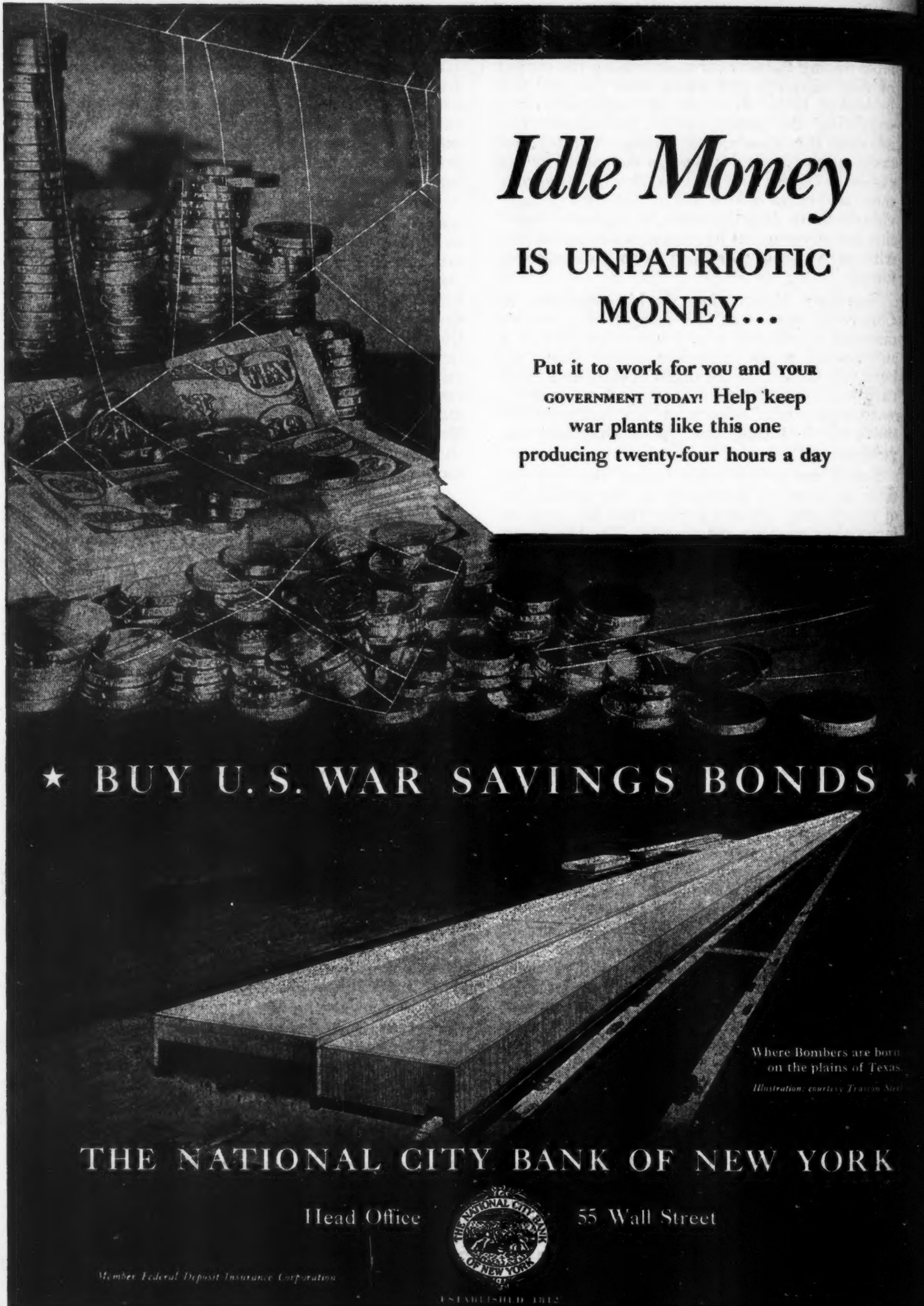
Reserve Banks and the Bill Market

The announcement by the Federal Reserve Board that the Reserve Banks will stand ready to buy all Treasury bills offered at ⅜ per cent represents an integral part of the financial program. To finance the enormous borrowing ahead, banks will need additional reserve and the purchase of bills by the Reserve Banks is a way of supplying such reserve as the market requires. Banks and other investors can proceed more confidently in support of the Treasury's program if they have this assurance of the availability of adequate reserves, and can buy bills with the knowledge that they are practically the equivalent of cash. At a time when the Reserve Bank rediscount rates are not effective, due to lack of rediscounts, the buying rate for Treasury bills becomes in a sense the effective discount rate, just as for many years the real discount rate in London was the buying rate for bankers' acceptances.

During the past month (with the increase of volume of short dated paper) the Treasury bill rate has moved up from around 0.20 per cent to 0.335 per cent, highest since 1937. Reserve Bank bill holdings increased $89,000,000.

As in the case of the 6 months certificates the Treasury has enlisted the aid of bankers and investment bankers in a sales effort to bring the new securities to the attention of prospective buyers, and thus bring about the widest possible distribution of the new issues.

Thus step by step the Treasury, with the cooperation of the Reserve System and the banking community, is working out a program for financing the war. Part of the program is frankly experimental, but the task is great and there is need for energy and resourcefulness.



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